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IN THE

Supreme Court of the United States

OCTOBER TERM, 1941

No.

WEST PRODUCTION COMPANY, *Petitioner*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT.

PETITION.

The West Production Company, by its counsel, prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Fifth Circuit entered July 7, 1941, affirming a decision of the United States Board of Tax Appeals.

Opinions Below.

The opinion of the United States Board of Tax Appeals (R. 91-108) is published at 41 B. T. A. 1043. The opinion of the Circuit Court of Appeals (R. 143-147) is reported in 121 F. (2d) 9.

Jurisdiction.

The judgment of the Circuit Court of Appeals sought to be reviewed was entered July 7, 1941. Jurisdiction to issue the writ requested is found in Section 240 of the Judicial Code, as amended by the Act of February 13, 1925.

Question Presented.

A debtor failed to pay taxes and other charges on collateral securing notes. To protect its interest, the creditor was compelled to foreclose and buy in the collateral. Is the price bid at the foreclosure sale, or the fair market value of the assets acquired, to be used in computing gain or loss for Federal tax purposes?

Statutes and Regulations Involved.

The statutes and regulations involved are set forth in the appendix, *infra*, pp. 14-36.

Summary Statement of Matter Involved.

Several issues were involved in this case in the court below. Certiorari is sought on one issue only. It involves the following facts:

October 27, 1931, R. S. Sterling obtained a loan from a bank in the amount of $800,000.00 secured by various properties pledged under a deed of trust. The loan was evidenced by notes.

On June 20, 1932, the West Production Company purchased the outstanding notes for $324,039.00. After the purchase of the notes, the West Production Company received $118,891.98 previously paid on the loan, plus $165,000.00 realized from the sale, with Sterling's consent, of part of the collateral, thus making its net cost of the remaining notes $40,147.02.

Sterling failed to pay taxes and other charges on the properties covered by the deed of trust. Accordingly, the properties were sold October 4, 1932, at public auction on

the steps of the Harris County, Texas, Courthouse. At that time there were accrued and unpaid taxes due on the properties, and payments were also due on account of the principal of loans against the properties. One property alone had a debt of $143,000.00 against it.

At the sale the persons in attendance were given the opportunity to bid on any separate item of personal or real property. The West Production Company bid in the real property for $17,300.00, and the personal property for $1,500.00, a total of $18,800.00. The Sterling notes were not cancelled and are still in the possession of the West Production Company.

The Commissioner of Internal Revenue held that the properties acquired at the foreclosure had a fair market value on October 4, 1932, of $205,414.00; that the bid price on foreclosure should be ignored, and that the West Production Company realized a taxable profit on the purchase.

The parties stipulated that "In the event the Board should hold that the values as of date of acquisition should be considered in computing income of petitioner", the fair market value of the properties purchased, as of October 4, 1932, was $101,522.77.

By using the stipulated value, rather than the bid price, the Board of Tax Appeals held that the West Production Company realized a gain on the purchase of $61,375.75. The Circuit Court of Appeals affirmed the Board of Tax Appeals.

Both decisions below were based on Article 193, Treasury Regulations 77, promulgated under Section 23 of the Revenue Act of 1932, which deals with deductions from gross income, and not with gain, and which states that gain or loss can be realized by a purchase at foreclosure.

Specification of Errors to be Urged.

The Circuit Court of Appeals erred:

(1) In holding that the bid price of the assets purchased at foreclosure sale was not to be used in computing Federal tax.

(2) In holding that the stipulated fair market value of the assets acquired, rather than the bid price at a foreclosure sale, was to be used in computing the Federal tax of the purchaser.

(3) In basing its decision on a regulation dealing with deductions from gross income and which has no statutory authority for taxing gains on purchase at foreclosure.

Reasons Relied on for the Allowance of the Writ.

I.

The basic question is pending before this Court and is in a state of conflict and confusion.

Several cases are now pending before this Court involving situations where bondholders or creditors bought in the debtor's property at foreclosure. The cases present two questions:

(1) Were the transactions statutory "corporate reorganizations" and

(2) Is the basis for computing depreciation (a) the cost to the predecessor organization, (b) the bid price, or (c) the fair market value on the date of acquisition. Circuit Courts of Appeals' decisions hold all three ways.

In the cases mentioned, the Government takes the position that the bid price establishes the basis. We believe that position to be correct and that justice demands the writ issue in this case in order that this taxpayer be placed on the same footing as other taxpayers buying property at foreclosure.

The cases pending before this Court are:

Nos. 128 and 129, *Bondholders Committee etc.* v. *Helvering* and *Marlborough House Inc.* v. *Helvering*, 118 F. (2d) 511. The Government's memorandum does not oppose certiorari and states (p. 2):

> "The question is the basis for depreciation, under Sections 23 (k), 113 and 114 (a) of the Revenue Act of

> 1932, of corporate assets bought in at equity foreclosure sale by a bondholders' committee * * *."

The Circuit Court of Appeals for the Ninth Circuit held that the basis was the price paid at the foreclosure sale. On page 3, the Government's memorandum states:

> "Accordingly, although we believe the instant case was correctly decided by the court below, we do not oppose the granting of the writs in view of the conflict between the circuits and the manifest importance of the question in the administration of the revenue laws."

No. 286, *Commissioner* v. *Southwest Consolidated Corporation,* 119 F. (2d) 561. The Fifth Circuit held there was a statutory reorganization, so the assets took the basis of the predecessor corporation. The Government's petition says the Fifth Circuit committed error in holding there was a "reorganization" and (p. 5):

> "In failing to hold that the basis of the assets was their cost to the bondholders' committee at the foreclosure and receivership sales."

No. 328, *Commissioner* v. *Alabama Asphaltic Limestone Co.,* 119 F. (2d) 819, is also a Fifth Circuit case wherein it was held that there was a statutory reorganization. In the Government's petition, it is alleged that error was committed by the Circuit Court of Appeals in holding there was a reorganization and (p. 5):

> "In failing to hold that the basis of the assets was the cost to the creditors' committee at the bankruptcy sale."

No. 503, *Palm Springs Holding Corporation* v. *Helvering,* 119 F. (2d) 846 (C. C. A. 9). The Government's memorandum states (pp. 2-3):

> "The Court below sustained the Commissioner's determination that the basis for depreciation was the cost of the property at the foreclosure sale * * *. Accordingly, although we believe the instant case was cor-

rectly decided by the court below, we do not oppose the granting of the writ in view of the conflict among the circuits and the importance of the question in the administration of the revenue laws."

July 14, 1941, the Eighth Circuit decided *Helvering* v. *New President Corporation,* not yet officially reported, but reported at ¶62,831, Prentice-Hall Federal Tax Service, wherein it was held that the fair market value, and not the bid price, was to be used as the basis of assets purchased at foreclosure. Counsel is informed that the Government will seek certiorari in the *New President* case.

The only difference between the cases cited and the case at bar is that in the cited cases the debtor was a corporation, while in the case at bar the debtor was an individual.

In the case at bar, it was held that the bid price did not govern and that inquiry must be made to determine the "fair market price". That position is directly contrary to the position taken by the Government in the above listed cases in this Court.

II.

Decision of the cases pending in this Court will affect the problem in the case at bar.

The statute provides that the basis for determining gain or loss, and for depreciation and depletion, is cost, increased or decreased by certain adjustments not applicable here. (Secs. 113 and 114, Revenue Act of 1932.)

In the several cases now pending before this Court, the Government is insisting that cost is the proper basis in the case of property bought at foreclosure. Such a position is obviously correct, as the law is established that actual cost paid at a foreclosure sale establishes the said basis, irrespective of fair market value. *Pelham Hall Co.*, 33 B. T. A. 329; *La Arcada Bondholders Committee*, 35 B. T. A. 80.

Consequently, in the case at bar the taxpayer must use its cost of $18,800.00, as the basis for determining gain or

loss or depreciation and depletion. Yet, the Commissioner of Internal Revenue has treated as income, and taxed, the difference between $18,800.00 and $101,522.77!

There is absolutely no statutory provision which will enable the taxpayer to recover through sale, or by depreciation, the difference between the price paid and the "fair market value", as of the date of the foreclosure sale.

Is this Court going to hold, as the Government contends in the pending cases, that the basis of property purchased at foreclosure is the actual cost thereof, and yet permit the purchaser to be taxed on an amount in excess of the price paid? The two questions are inseparably joined and if certiorari is not granted in this case, the question will inevitably arise in other cases. The Court should dispose of the entire problem at this time.

III.

The decision below is in conflict with a decision of this Court which holds that the bid price governs and that a mortgagee who purchases at foreclosure is in a position no different from that of a stranger.

In *Helvering* v. *Midland Mutual Life Insurance Co.*, 300 U. S. 216, the Court was asked to decide if a mortgagee realized interest income when it bought property at foreclosure on a bid of the amount of the loan plus accrued and unpaid interest. The Court states the situation as follows (p. 233):

> "A mortgagee who, at foreclosure sale, acquires the property pursuant to a bid of the principal and accrued interest is, as purchaser and grantee, in a position no different from that of a stranger who acquires the property on a bid of like amount. It is true that the latter would be obliged to pay in cash the amount of his bid, while the formality of payment in cash is ordinarily dispensed with when the mortgagee acquires the property on his own bid. But the rights acquired *qua* purchasers are the same in either case; * * *"

While life insurance companies are not taxed on capital transactions, obviously the rule of the Midland case is general and applies to individual and ordinary corporation taxpayers. If a mortgagee and a stranger are in the same position when buying property at foreclosure, it is obvious that no income was realized when the West Production Company purchased the property here involved, because if a stranger had purchased, he would not be subject to tax until the property was sold. "A mortgagee * * * is in a position no different from that of a stranger".

It is no answer to the Midland decision to say that the case involved a narrow question of whether a life insurance company had received "interest". The entire basis of the decision is that a mortgagee has the same standing as a stranger.

The Ninth Circuit has followed the Midland Mutual case by holding that, for tax purposes, the bid price governs irrespective of the actual value of the assets purchased. *Tiscornia* v. *Commissioner*, 95 F. (2d) 678, involved a situation wherein the trustee for certain noteholders foreclosed and bid in the property securing the notes. The trustee then gave to each noteholder his proportionate shares of stock in a new corporation to which the assets were transferred. A question arose as to the cost of the property acquired at the foreclosure sale. The Court says (p. 683):

> "We hold upon the authority of *Helvering* v. *Midland Mutual Life Insurance Co.*, 1937, 300 U. S. 216, that for the purpose of the present tax calculation, the cost of this property to petitioner is established by the bid price thereof at the foreclosure sale, without regard to its actual market value. * * * If mortgage principal, plus interest thereon, is considered for tax purposes to be recovered when property is acquired on a bid equal to their total, then it follows that the cost of the property so acquired is for tax purposes the amount bid therefor."

IV.

The Treasury Regulation that gain can be realized by a purchase at foreclosure is based on the loss section of the statute and is invalid. The action of the court below in upholding such a Regulation is in conflict with many decisions.

It can be safely stated that income is not realized by the purchase of property, no matter how favorable the purchase may be.

> "Normally, the purchase of property does not result in the realization of taxable gain, but rather in the acquisition of an asset with a view to the later realization of gain or profit through its use or subsequent sale * * *". *Delbert B. Geeseman,* 38 B. T. A. 258, 263.

The same case also states (p. 264):

> "Furthermore, it is not at all unusual that the purchaser of property may through his ability and shrewdness as a buyer, or by reason of other influences or forces, be able to purchase property at a price substantially lower than the price at which it may be immediately sold, but it does not follow that gain is presently realized through such a purchase." (Citing authorities)

Let us assume that a member of this Court invested in a real estate mortgage note. After buying the note, he discovered taxes were delinquent and, if he were to save his investment in the note, he must foreclose and buy in the property. Would he realize income by this continuing outgo of cash?

There is absolutely no statutory provision which authorizes the computation of a gain by purchase. Section 22 defines gross income and specifically includes income from sales.

Section 23 authorizes certain deductions from gross income, including losses.

Section 111 deals with the computation of gain or loss from "the sale or other disposition of property".

Section 112 covers recognition of gain or loss determined under Section 111.

Sections 113 and 114 deal with the basis for determining gain or loss and for depreciation and depletion, respectively.

Nowhere in the statute covering income is mention made of purchases, and gain from purchases cannot possibly be read into the statute. Despite this, Article 193 of Regulations 77, interpreting deductions from income under Sec. 23 of the statute, provides that gain or loss is realized upon a purchase by a creditor at foreclosure. Such a regulation has been in force since the Revenue Act of 1926. (The year here involved is 1932.) The rule to be followed is well expressed in *Koshland* v. *Helvering*, 298 U. S. 441, 445:

> "We give great weight to an administrative interpretation long and consistently followed, particularly when the Congress, presumably with that construction in mind, has re-enacted the statute without change. The question here, however, is not merely of our adopting the administrative construction but whether it should be adopted if in effect it converts an income tax into a capital levy."

The Court then holds that the Treasury is without power to enlarge the statute by regulations.

In *Manhattan General Equipment Co.* v. *Commissioner*, 297 U. S. 129, it is stated (p. 134):

> "The power of an administrative officer or board to administer a federal statute and to prescribe rules and regulations to that end is not the power to make law—for no such power can be delegated by Congress— • • • ".

In this case the Commissioner of Internal Revenue by regulation has attempted to make law by ruling that income is realized by purchase. Obviously, the regulation attempts to enlarge the statute and is a nullity.

It should be mentioned that the case at bar apparently is the only case in which the Courts have upheld the regula-

tion to tax a gain, unless *Helvering* v. *New President Corporation,* (C. C. A. 8), not yet officially reported but reported at ¶ 62,831 Prentice-Hall Federal Tax Service, is finally construed to so hold. The other reported decisions allow losses in hard cases.

It should be remembered that Sec. 23 of the statute deals with losses and other deductions from gross income, so the decisions allowing losses on foreclosures are justified. There is no corresponding statutory provision authorizing the taxation of gains on purchase at foreclosure.

IV.

The decisions of the Board of Tax Appeals support the taxpayer's contentions.

The Board of Tax Appeals in the unreported memorandum opinion[1] in *Egbert J. Henschel* v. *Commissioner,* Docket No. 83783, promulgated April 30, 1938, ¶ 6.207 Prentice Hall Federal Tax Service for 1938 was confronted with a situation where the decedent in 1927 sold certain real estate and took back a purchase money mortgage for $12,500.00. In 1934 the mortgage was in default and was foreclosed. The taxpayer bid $8,000.00 for the property. Expenses of sale and taxes amounted to $1,325.00. The Commissioner held that, on the date of the foreclosure sale, the fair market value of the property was $22,000.00 and determined that the taxpayer had realized a gain of $8,175.00. The Board states:

> "The real question in this proceeding is whether petitioners' decedent realized any gain or loss in 1934 on the personal property he held, namely a claim against a debtor for $12,500 secured by a mortgage on realty, when decedent foreclosed the mortgage. Respondent has treated the foreclosure as an exchange of personal property for real property and refers to our decision

[1] Memorandum opinions are rendered by the Board in cases where the law on the subject involved is settled, or where the peculiar facts in the case would not make it a precedent.

in *Henry Heldt*, 16 B. T. A. 1035. The facts in this proceeding are different from the facts in the *Heldt* case. There a creditor did exchange a note secured by a mortgage for a deed to the mortgaged realty. The creditor gave $1,000 cash and cancelled a note with accrued interest due in consideration for a deed to realty. We held there that the transaction constituted an exchange of one asset for another that gave rise to gain to the creditor, who was the petitioner in that case. However, here the petitioners' decedent neither sold nor exchanged the property consisting of his claim. He realized on the security he held, which at sale brought $8,000.00, which was applied in partial satisfaction of the claim against a debtor. Partial satisfacton of an obligation does not constitute a sale or exchange of the obligation. See *Hale* v. *Helvering*, 85 Fed. (2) 819. We hold, therefore, that petitioners' decedent realized no gain from applying the value of the collateral in partial satisfaction of the debt to him."

The case of *Manomet Cranberry Co.*, 1 B. T. A. 706, acquiesced in by the Commissioner, C. B. June 1925, p. 3, arose under an earlier Treasury Regulation. In that case, the taxpayer sold property in 1916 and took back a mortgage. In 1919 it bought back the property on foreclosure. The Board said the Commissioner should not treat the transaction in a manner "where the result may be to impose a tax upon the increment which may never be realized", stating (p. 709):

> "There is no evidence to show that the property was worth more than the price so paid for it; but, even if there were, it would not constitute a realized gain until such time as the property might be disposed of."

The *Manomet* case was followed by the Board in *I. M. Davis*, 2 B. T. A. 359, the Board stating (p. 360):

> "We think that the contention of the taxpayer is correct in that there would be no realized gain in the repossession of the property by the taxpayer until such time as the property might be disposed of."

One line of cases, illustrated by *Henry Heldt*, 16 B. T. A. 1035, holds that where the debtor transfers the purchased property back to the seller, there is an exchange by the creditor of his debt asset for a property asset and gain or loss results. The case at bar differs from this line of cases because: (1) the taxpayer did not sell and later repossess the property involved and (2) the debt asset was not exchanged for the property asset.

The Board of Tax Appeals' decision in the case at bar is based on *Hadley Falls Trust Co.* v. *U. S.* (C. C. A. 1), 110 F. (2d) 887, which allowed a loss on the foreclosure of a mortgage. The Court clearly points out that its conclusion is based on Sec. 23 of the Revenue Act of 1928, which specifically allows deductions for losses and bad debts. There is no such statutory provision permitting the taxing of gain on foreclosure.

Conclusion.

For the foregoing reasons, it is respectfully submitted that this petition should be granted, limited to the purchase at foreclosure issue.

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September 1941.